

**STATE OF ALABAMA**  
**DEPARTMENT OF INSURANCE**  
**MONTGOMERY, ALABAMA**

**REPORT ON EXAMINATION**

**as of**

**DECEMBER 31, 2001**

**of**

**ALFA MUTUAL FIRE**  
**INSURANCE COMPANY**

**MONTGOMERY, ALABAMA**

**PARTICIPATION:**

**Alabama**

**EXAMINATION AFFIDAVIT**

**STATE OF ALABAMA  
COUNTY OF MONTGOMERY**


Rex H. Newborn being first duly sworn, upon his oath deposes and says:

That he is an examiner appointed by the Commissioner of Insurance for the State of Alabama;


That an examination was made of the affairs and financial condition of Alfa Mutual Fire Insurance Company for the period of January 1, 1998 through December 31, 2001;

That the following 32 pages constitute the report thereon to the Commissioner of Insurance of the State of Alabama;

And, that the statements, exhibits, and data therein contained are true and correct to the best of his knowledge and belief.

  
\_\_\_\_\_  
Rex H. Newborn  
Examiner-in-charge

Subscribed and sworn to before the undersigned authority this 16<sup>th</sup> day of July, 2004.

  
\_\_\_\_\_  
(Signature of Notary Public)

Debra L. Meadors, Notary Public  
Printed name

in and for the State of Alabama

My commission expires 7/22/2006

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Montgomery, Alabama  
February 20, 2004

Honorable Jose Montemayor  
Chairman, Examination Oversight Task Force  
Texas Department of Insurance  
P.O. Box 149104  
Austin, TX 78714-9104

Honorable Alfred W. Gross  
Secretary Southeastern Zone  
Virginia Bureau of Insurance  
P.O. Box 1157  
Richmond, Virginia 23218

Honorable Walter A. Bell  
Commissioner of Insurance  
Alabama Department of Insurance  
Post Office Box 303350  
Montgomery, Alabama 36130-3350

Dear Commissioner Bell:

Pursuant to your instructions and in compliance with the statutory requirements of the State of Alabama and the resolutions adopted by the National Association of Insurance Commissioners, an examination has been made of the affairs and condition of

**Alfa Mutual Fire Insurance Company  
Montgomery, Alabama**

as of December 31, 2001, at its home office located at 2108 East South Boulevard, Montgomery, Alabama 36116. The report of examination is submitted herewith.

Where the term, Company, appears herein without qualification, it is synonymous with Alfa Mutual Fire Insurance Company.

## **SCOPE OF EXAMINATION**

The examination reported herein covers the period from December 31, 1997 through December 31, 2001, and has been conducted by examiners representing the Alabama Department of Insurance. The Company's insurance affiliates (five property and casualty companies, and one life insurance company) have been examined concurrently with the examination of the Company. Events subsequent to December 31, 2001, have been reviewed as required and are reported herein as deemed appropriate.

The Company has been examined in accordance with the statutory requirements of the Alabama Insurance Code and the regulations and bulletins of the Alabama Department of Insurance; in accordance with the applicable guidelines and procedures of the NAIC; and in accordance with generally accepted examination standards.

The examination included a general review of the Company's operations, administrative practices and compliance with statutes and regulations. Income and disbursement items were tested for selected periods. Assets were verified and valued and all known liabilities were established or estimated as of December 31, 2001, as shown in the financial statements contained herein.

In compliance with requirements of the Alabama Department of Insurance, the President and Treasurer of the Company executed a letter of representation certifying that the Company had valid title to all its reported assets, and that it did not have unreported liabilities as of December 31, 2001.

Within this report, discussion of the Company's accounts has been confined to those items for which a material change in the financial statements has been noted or for which comments and/or recommendations have been made.

## **ORGANIZATION AND HISTORY**

The Company was incorporated May 1, 1945 under the name, Alabama Farm Bureau Mutual Insurance Services, Inc. It was organized as a mutual insurance company by the Alabama Farm Bureau Federation (AFBF), to provide fire and allied fires insurance to the members of the AFBF.

Effective May 1, 1987, AFBF withdrew from the national Farm Bureau Federation, of which it was a franchise member, and changed its name to Alabama Farmers Federation. The name of the Company was changed to Alfa Mutual Fire Insurance Company.

During the interim from the Company's organization through 1987, the Company became affiliated with four other property and casualty insurers. In 1987 a reinsurance pooling agreement was formed between these five affiliates. The terms of the agreement provide that all direct business of the affiliates will be ceded to Alfa Mutual Insurance Company (AMI). The pooled business is then retroceded according to percentages provided in the pooling agreement. In 1989 an intercompany reinsurance pooling committee, representing the boards of directors of the reinsurance pool participants, was established. This committee is responsible for reviewing and approving any changes to the pooling agreement, to assure that transactions are fair and equitable to all pool participants, and to monitor potential, or actual, conflicts of interest between pool participants.

In 1999, Alfa Specialty Insurance Corporation (ASI) was organized as a stock company, wholly-owned by AMI. ASI became a participant in the reinsurance pooling agreement in 2001.

No significant amendments to the Company's Articles of Incorporation or By-laws, or other events of an organizational or historical nature were noted during the examination period.

### **GROWTH OF THE COMPANY**

The following schedule presents financial data, which reflect the growth of the Company for the years indicated:

| <i><u>Year</u></i> | <i><u>Gross Premiums<br/>Written</u></i> | <i><u>Admitted<br/>Assets</u></i> | <i><u>Liabilities</u></i> | <i><u>Policyholders'<br/>Surplus</u></i> |
|--------------------|--|-----------------------------------|---------------------------|--|
| 1997               | (9,278,070)                              | 475,033,486                       | 34,567,730                | 440,465,756                              |
| 1998               | 31,923                                   | 515,815,759                       | 36,177,800                | 479,637,960                              |
| 1999               | 2,484,334                                | 564,070,055                       | 33,307,053                | 530,763,003                              |
| 2000               | 5,723,894                                | 599,571,060                       | 34,713,414                | 564,857,648                              |
| 2001               | 143,039,257                              | 684,159,065                       | 120,685,485               | 563,473,580                              |

Data for the years 1997 and 2001 are per examination. Data for the remaining years were obtained from the Company's Annual Statements.

## **TERRITORY**

As of December 31, 2001, the Company was licensed to transact insurance business in the following jurisdictions:

Alabama

North Carolina

Virginia

The Certificates of Authority from the respective jurisdictions were inspected and found to be in effect at December 31, 2001.

## **STATUTORY DEPOSITS**

In compliance with statutory requirements for transacting insurance business in the respective jurisdictions, the Company had the following securities on deposit at December 31, 2001:

### Deposits Held for the Benefit of Policyholders, Claimants, and Creditors of the Company

|  | <u>Par<br/>Value</u> | <u>Statement<br/>Value</u> | <u>Market<br/>Value</u> |
|--|----------------------|----------------------------|-------------------------|
| <u>Alabama</u>   |                      |                            |                         |
| Compass Bank, U.S. Treasury<br>Note, 7.625%, due 2/15/07 | \$125,000            | \$125,032                  | \$125,781               |
| <u>Virginia</u>  |                      |                            |                         |
| Suntrust Bank, U.S. Treasury<br>Note 4.75%, due 11/15/08 | <u>300,000</u>       | <u>291,574</u>             | <u>298,875</u>          |
| Totals   | <u>\$425,000</u>     | <u>\$416,606</u>           | <u>\$424,656</u>        |

All statutory deposits were confirmed as of December 31, 2001, by written correspondence with the respective custodians.

### Reinsurance Deposits

At December 31, 2001, the Company had securities pledged under security fund agreements relating to various reinsurance contracts. The aggregate values of said securities are as follows:

(continued next page)



| <u>Reinsurer</u>                      | <u>Par<br/>Value</u> | <u>Statement<br/>Value</u> | <u>Market<br/>Value</u> |
|---------------------------------------|----------------------|----------------------------|-------------------------|
| General Agents                        | \$ 5,504             | \$ 5,504                   | \$ 5,504                |
| National Union Fire Insurance Company | 8,157,850            | 8,192,665                  | 8,603,414               |
| St. Paul Fire and Marine              | <u>17,885,000</u>    | <u>17,998,560</u>          | <u>18,007,926</u>       |
| Totals                                | <u>\$26,048,354</u>  | <u>\$26,196,729</u>        | <u>\$26,616,844</u>     |

## **HOLDING COMPANY AND AFFILIATES**

### **Holding Company Registration and Reporting**

The Company is deemed to be subject to the Alabama Insurance Holding Company Regulatory Act of 1973, as defined in Section 27-29-1, *Code of Alabama*, 1975. The Company is responsible for holding company registration and periodic informational filings with the Alabama Department of Insurance, in accordance with Section 27-29-4, *Code of Alabama*, 1975, and Alabama Department of Insurance *Regulation Number 55*.

Holding Company filings and amendments to registration statements made on behalf of the Company and its affiliates, for the years under examination, were reviewed. Said filings and amendments were found to be substantially complete and to reflect the required disclosures.

### **Organization Chart**

The chart on the following page depicts the insurance holding company system with which the Company was affiliated as of December 31, 2001.

The organizational chart for Virginia Mutual Insurance Company (VMI) illustrates the ownership structure of its various subsidiaries and related entities. The chart is organized into several columns, with ownership percentages indicated by boxes and connecting lines.

- Top Level (Parent Company):** VIRGINIA MUTUAL INSURANCE COMPANY (54-0417660, 18791 VA).
- Second Level (Major Subsidiaries):**
  - ALFA MUTUAL GENERAL INSURANCE COMPANY (63-0412063, 19151 AL)
  - ALFA MUTUAL FIRE INSURANCE COMPANY (63-0255547, 19143 AL)
  - ALFA MUTUAL INSURANCE COMPANY (63-0282184, 19135 AL)
- Third Level (Subsidiaries of ALFA MUTUAL GENERAL INSURANCE COMPANY):**
  - ALFA INSURANCE CORPORATION (63-0351201, 22330 AL)
  - ALFA GENERAL INS. CORPORATION (63-0835706, 41661 AL)
  - ALFA LIFE INSURANCE CORPORATION (63-0338648, 79049 AL)
  - ALFA FINANCIAL CORP. (63-0519875)
  - ALFA AGENCY GA. INC. (58-2583007)
  - ALFA AGENCY MS INC. (64-0800228)
  - ALFA REALTY INC. (63-0918666)
  - ALFA BENEFITS CORP. (63-1229837)
  - ALFA INVESTMENT CORP. (63-0644262)
- Third Level (Subsidiaries of ALFA MUTUAL FIRE INSURANCE COMPANY):**
  - ALFA SPECIALTY INS. CORP. (63-1232537, 11004 AL)
  - ALFA CORPORATION (63-0838024)
- Third Level (Subsidiaries of ALFA MUTUAL INSURANCE COMPANY):**
  - ALFA AGENCY ALABAMA INC. (63-1090619)
  - SOUTHERN BOULEVARD CORPORATION (63-0594845)
  - FAIRFIELD CO. PARTNERSHIP (63-1032285)
  - ALFA VENTURES, INC. (63-1230726)
  - ALFA VENTURES II, L.L.C. (63-1248888)
  - ALFA INVESTORS LTD. PARTNERSHIP I (51-0369873)
  - ALFA INVESTORS LTD. PARTNERSHIP II (51-0369874)
  - ALFA BUILDERS INC. (63-0734294)
- Fourth Level (Subsidiaries of ALFA VENTURES, INC.):**
  - ALFA INVESTORS (63-1064148)
  - EASTCHASE LAND COMPANY, L.L.C. (63-1248606)
- Ownership Percentages:**
  - ALFA MUTUAL GENERAL INSURANCE COMPANY owns 100.00% of ALFA INSURANCE CORPORATION, 100.00% of ALFA GENERAL INS. CORPORATION, 100.00% of ALFA LIFE INSURANCE CORPORATION, 100.00% of ALFA FINANCIAL CORP., 100.00% of ALFA AGENCY GA. INC., 100.00% of ALFA AGENCY MS INC., 100.00% of ALFA REALTY INC., 100.00% of ALFA BENEFITS CORP., and 100.00% of ALFA INVESTMENT CORP.
  - ALFA MUTUAL FIRE INSURANCE COMPANY owns 100.00% of ALFA SPECIALTY INS. CORP. and 100.00% of ALFA CORPORATION.
  - ALFA MUTUAL INSURANCE COMPANY owns 100.00% of ALFA AGENCY ALABAMA INC., 100.00% of SOUTHERN BOULEVARD CORPORATION, 100.00% of FAIRFIELD CO. PARTNERSHIP, 100.00% of ALFA VENTURES, INC., 100.00% of ALFA VENTURES II, L.L.C., 100.00% of ALFA INVESTORS LTD. PARTNERSHIP I, 100.00% of ALFA INVESTORS LTD. PARTNERSHIP II, and 100.00% of ALFA BUILDERS INC.
  - ALFA VENTURES, INC. owns 100.00% of ALFA INVESTORS and 100.00% of EASTCHASE LAND COMPANY, L.L.C.
  - ALFA VENTURES II, L.L.C. owns 50.00% of ALFA INVESTORS LTD. PARTNERSHIP I and 50.00% of ALFA INVESTORS LTD. PARTNERSHIP II.
  - ALFA INVESTORS LTD. PARTNERSHIP I owns 1.00% of ALFA INVESTORS LTD. PARTNERSHIP II.
  - ALFA INVESTORS LTD. PARTNERSHIP II owns 1.00% of ALFA BUILDERS INC.
  - ALFA INVESTORS owns 13.50% of ALFA INSURANCE CORPORATION, 13.50% of ALFA GENERAL INS. CORPORATION, 13.50% of ALFA LIFE INSURANCE CORPORATION, 10.00% of ALFA FINANCIAL CORP., 10.00% of ALFA AGENCY GA. INC., 10.00% of ALFA AGENCY MS INC., 10.00% of ALFA REALTY INC., 10.00% of ALFA BENEFITS CORP., and 10.00% of ALFA INVESTMENT CORP.
  - ALFA BUILDERS INC. owns 1.00% of ALFA INVESTORS LTD. PARTNERSHIP II.

## **Agreements with Affiliates**

### **Management and Operating Agreement**

The following insurers were under the control of Alfa Mutual Insurance Company (AMI) and were parties to a Management and Operating Agreement with AMI: the Company; Alfa Mutual General Insurance Company; Alfa Insurance Corporation; Alfa General Insurance Corporation; Alfa Specialty Insurance Corporation; and, Alfa Life Insurance Corporation. These companies will be referred to, collectively, as the "affiliates" in the remainder of the discussion of this topic.

This agreement has been in effect since January 1, 1960, with periodic amendments to modify the terms and to add companies as they became affiliated. Effective January 1, 1990, it was revised to continue on an annual basis through December 31, 2001. After that date, the agreement has been extended for additional periods of one year each.

Pertinent terms of the agreement include the following:

- 1) The affiliates designate AMI to take charge of, conduct, operate and manage the business of the affiliates, respective to each affiliate's charter and Board of Directors, and in a manner conducive to the profitable operation of each respective affiliate. AMI will provide all home office operating services to the affiliates, including accounting, disbursement and payroll services and will serve as a disbursing agent for the payment of all employees and agents of the affiliates.
- 2) AMI agrees to employ, in its own name, all personnel necessary to perform the aforesaid, and reserves all rights and responsibilities of the employer of said personnel. All agents of the affiliates shall be appointed in the name of the respective affiliates and shall work on behalf of the respective affiliates. All personnel and agents of any affiliate employed outside Alabama are the sole responsibility of that affiliate. AMI also agrees to indemnify and hold the affiliates harmless against any loss on account of the dishonesty or infidelity of any AMI employees.
- 3) AMI agrees that the business of each party to the agreement shall be conducted in the name of the respective party and that the records of each party shall be kept separately. AMI Company agrees to provide all required records, record-keeping services and data processing necessary to the efficient and economical operation of such business.
- 4) The affiliates agree to reimburse AMI for expenses and additional charges in accordance with schedules which are attached to the agreement. These schedules are subject to periodic amendment. Expense allocations and

other charges are determined by time, usage, and related special expense allocation studies conducted by AMI. Expenses entirely attributable to the affiliates such as printing and supplies are purchased and paid for directly by the respective affiliate.

Numerous expense categories are prorated between affiliates on Schedule A, an attachment to the agreement. Certain other expenses are allocated directly to the affiliates that benefit from expenditures. Agent's commissions are allocated 100% to the affiliate writing the business. Fixed monthly charges are paid by the affiliate for certain other expenses.

### **CORPORATE RECORDS**

The Company's Articles of Incorporation, By-Laws and amendments thereto were inspected and found to provide for operation of the Company in accordance with Alabama statutes and regulations and with accepted corporate practices.

Minutes of the meetings of the stockholders, board of directors and committees of the Company, from December 31, 1997 through the most recent meetings recorded at the time of examination, were reviewed. The minutes appeared to be complete and to adequately document the actions of the respective governing bodies.

### **MANAGEMENT AND CONTROL**

#### **Policyholders**

The Company is a mutual insurance corporation with ownership vested in its policyholders. Membership in the Alabama Farmers Federation is a prerequisite for the purchase of insurance from any of the mutual insurance companies within the Alfa Insurance Group.

#### **Board of Directors**

The Company's By-Laws provide that its property and business shall be managed by a board of directors consisting of eighteen directors. Directors are elected at the annual meeting of the general membership and serve until their successors are elected and qualified. The following directors were serving at December 31, 2001:

Director/Residence

Jerry Allen Newby  
Athens, Alabama

Luther Olen Bishop  
Cherokee, Alabama

Waymon Buttram  
Geraldine, Alabama

William Bert Driskell  
Grand Bay, Alabama

Stephen Leonard Dunn  
Evergreen, Alabama

Carl Otis Godsey  
Houston, Alabama

William Townsend Kyser  
Greensboro, Alabama

Hal Franklin Lee  
Hartselle, Alabama

Benjamin Philip Martin  
Enterprise, Alabama

Jon Henry Miller  
Cottondale, Alabama

Marion Stanley Morris  
Ashville, Alabama

John Guy Neighbors  
Alexander City, Alabama

James Louis Parnell  
Stanton, Alabama

James Albert Tolar, Jr.  
Marion, Alabama

Principal Occupation

Chairman of the Board, CEO,  
and President, Company

Farmer

Farmer

Farmer

Treasurer, Company

Farmer

Farmer

Vice President (North Area), Company

Farmer

Farmer

Farmer

Farmer

Farmer

Vice President (Southwest Area), Company

(continued next page)

Charles Clancy Turner, Jr.  
Black, Alabama

Farmer

Ronald Gray Vaughn II  
Huntsville, Alabama

Farmer

Russell Riley Wiggins  
Andalusia, Alabama

Vice President (Southeast Area), Company

Curtis Dean Wysner  
Woodland, Alabama

Vice President (Central Area), Company

### **Officers**

The Company's By-Laws provide that its principal officers shall be a chairman of the board, a president, four vice presidents, a secretary, a treasurer, and such other officers as the board of directors may determine, and for such terms, authority and duties as may be determined pursuant to the appointment. Any two or more offices may be held by the same person, except the offices of president and secretary. Unless otherwise designated, the President will be the CEO.

The following officers were elected by the board of directors and were serving at December 31, 2001:

|                         |                                |
|-------------------------|--------------------------------|
| Jerry Allen Newby       | President and CEO              |
| Hal Franklin Lee        | Vice President, North Area     |
| Russell Riley Wiggins   | Vice President, Southeast Area |
| Curtis Dean Wysner      | Vice President, Central Area   |
| James Albert Tolar, Jr. | Vice President, Southwest Area |
| Stephen Leonard Dunn    | Treasurer                      |
| Clyde Lee Ellis III     | Assistant Treasurer            |
| Herman Alan Scott       | Secretary                      |

The following officers were appointed by the board of directors and were serving at December 31, 2001:

|                          |   |
|--------------------------|---|
| Clyde Lee Ellis III      | Executive Vice President, Operations                  |
| Charles Wayne Hawkins    | Executive Vice President, Marketing                   |
| Stephen Goddard Rutledge | Senior Vice President, CFO & Chief Investment Officer |
| Herman Alan Scott        | Senior Vice President and General Counsel             |
| Jimmy Rogers Azar        | Senior Vice President, IA and Planning                |

(continued next page)

John Thomas Jung  
James Terry McCollum  
Thomas Earle Byrant  
Wyman Cabaniss  
Jerry Charles Ralph  
William Merit Hardy, Jr.  
John Daryl Holley  
Carol Lynn Golsan  
Linda Gail Harwell  
Kenneth Everette Stephens  
Elizabeth Vail Chancey  
David Ray Proctor  
Donald Eugene Manis  
Joanne Wilson  
Christine Gnann Cantrell  
Kevin Lee Ketzler  
Alfred Edwin Schellhorn  
Connie Leah Whitecotton  
Patti Jo Everage  
Michael Edward Epton  
Jacob Daniel Black

Senior Vice President, CIO  
Senior Vice President, Claims  
Senior Vice President, Human Resources  
Senior Vice President, P&C Underwriting  
Senior Vice President, Marketing, North Alabama  
Senior Vice President, Marketing, South Alabama  
Vice President and Assistant CFO  
Vice President, Marketing Services  
Vice President, Auto Underwriting  
Vice President, P&C Systems Implementation  
Vice President, P&C Underwriting  
Vice President, Taxes  
Vice President, Property Actuary  
Vice President, Professional Development  
Vice President, Marketing Communications  
Vice President, Real Estate  
Vice President, Mergers & Acquisitions  
Assistant Vice President, Internal Audit  
Assistant Vice President, Finance  
Assistant Vice President, Finance  
Assistant Vice President, Finance

### **Committees**

The following committees were appointed by the board of directors and were serving at December 31, 2001:

**Contributions Committee**

James Albert Tolar, Jr., Chairman  
Stephen Leonard Dunn  
Curtis Dean Wysner

**Pooling Committee**

Jerry Allen Newby, Chairman  
William Bert Driskell  
Luther Olen Bishop

**Executive Committee**

Jerry Allen Newby  
Hal Franklin Lee  
Russell Riley Wiggins  
Curtis Dean Wysner  
James Albert Tolar, Jr.  
Stephen Leonard Dunn

### **Conflict of Interest**

Conflict of interest statements executed during the examination period were reviewed through 1999. The Company's Policy Statement on Business Ethics and Conflicts of Interest, in effect prior to 2001, required all directors, officers, and employees to execute conflict of interest statements annually. Effective July 18, 2001, the Company adopted a new "Principles of Business Conduct." Because the drafting and adoption of this new policy was in process, there were no conflict of interest statements executed for the year 2000.

The new policy does not require annual conflict of interest statements. It has been amended, February 4, 2003, to incorporate the provisions required by the Federal Sarbanes-Oxley Act. Under the policy, all new employees are required to confirm their compliance with the policy at their hiring. Confirmations are obtained from all existing employees when the policy undergoes significant revision, or whenever circumstances dictate that reconfirmation would be helpful in reinforcing the Company's "tone at the top" message.

### **FIDELITY BOND AND OTHER INSURANCE**

The Company and its affiliates were covered by a fidelity bond through the Fidelity and Deposit Company of Maryland, at December 31, 2001. This policy provided for maximum coverage of \$2,000,000, which was in excess of the \$1,250,000 amount recommended by NAIC guidelines. Nevertheless, the policy covered twenty-two named insureds which were also affiliates of the Company. The application of the NAIC guidelines based on the assets and income of the Company alone is deemed not to provide an adequate amount of fidelity bond coverage for all the named insureds.

It was deemed to be beyond the scope of the examination to attempt to a consolidation of the assets and income of the subject affiliates in order to arrive at an adequate amount of fidelity bond. The Company has agreed to compute the required amount of fidelity bond, based on a consolidation, and to increase its coverage accordingly.

In addition to the above, the Company had the following coverages in effect at December 31, 2001, under policies issued directly to the Company or as a named insured under policies issued to an affiliate.

Professional Liability  
Boiler and Machinery  
Commercial Property

(continued next page)



General Liability  
Inland Marine  
Commercial Umbrella  
Worker's Compensation and Employer's Liability  
Business Automobile Insurance

The coverages and limits of the Company's insurance were reviewed and were deemed to adequately protect the Company's interest.

### **EMPLOYEE AND AGENTS' WELFARE**

The Company had no employees of its own during the examination period. Its operations are conducted by personnel employed by Alfa Mutual Insurance Company (AMI), under a management agreement that has been in effect since 1982. All employee and agents benefits for the Alfa Insurance Group are administered by AMI. Costs are allocated to the individual affiliates in accordance with the terms of the agreement.

### **REINSURANCE**

#### **Intercompany Reinsurance Pooling Agreement**

This agreement was effective August 1, 1987, between the Company and its affiliates: Alfa Mutual Insurance Company; Alfa Mutual General Insurance Company; Alfa Insurance Corporation; and, Alfa General Insurance Corporation. Alfa Specialty Insurance Corporation, incorporated in 1999, was added to the pool in 2001. These participants in the pooling agreement will be referred to as "the affiliates" for the remainder of this discussion. This reinsurance pooling agreement was filed with the Alabama Department of Insurance on July 29, 1987, and was subsequently approved. Pertinent terms of the agreement are as follows:

Initially, the affiliates ceded 100% of their book of business then in force to Alfa Mutual Insurance Company (AMI) and paid AMI their proportionate share of the net unearned premium less commissions at the provisional rate of 20%.

Currently, the affiliates cede 100% of the net liabilities for net premiums written to AMI and AMI retains or retrocedes the Pooled business in accordance with the following percentages:

|                           | 08/01/87 | 08/01/94 | 10/01/96 | 01/01/01 |
|---------------------------|----------|----------|----------|----------|
| Company                   | Pool 1   | Pool 2   | Pool 3   | Pool 4   |
| AMI                       | 32.0     | 24.0     | 32.0     | 18.0     |
| AMF                       | 15.0     | 8.0      | 0.0      | 13.0     |
| AMG                       | 3.0      | 3.0      | 3.0      | 3.0      |
| AGI                       | 25.0     | 32.5     | 32.5     | 32.5     |
| AIC                       | 25.0     | 32.5     | 32.5     | 32.5     |
| ASI (joined pool in 2001) |          |          |          | 1.0      |

Effective November 1, 1996, the affiliates amended the agreement to include catastrophe coverage. The following percentages are shown below for the Coinsurance Allocations for Catastrophe Losses and Related Expenses for the related years:

| Effective November 1, 1996   |                           |      | Effective July 1, 1999   |                           |      | Effective January 1, 2001  |                        |                       |
|--|---------------------------|------|--|---------------------------|------|--|------------------------|-----------------------|
| Cumulative<br>Calendar Year<br>Catastrophe<br>Losses and<br>Related Expenses | Coinsurance<br>Allocation |      | Cumulative<br>Calendar Year<br>Catastrophe Losses<br>and Related<br>Expenses | Coinsurance<br>Allocation |      | Cumulative<br>Calendar Year<br>Catastrophe Losses<br>and Related<br>Expenses | Coinsurance Allocation |                       |
|  | AGI                       | AMI  |  | AGI                       | AMI  |  | AGI                    | AMI, AMF,<br>AMG, ASI |
|  | AIC                       | AMG  |  | AIC                       | AMG  |  | AIC                    |                       |
| 10   | 65%                       | 35%  | 11   | 65%                       | 35%  | 11.4   | 65%                    | 35%                   |
| 19   | 0                         | 100% | 19   | 0                         | 100% | 19   | 0                      | 100%                  |
| 32   | 0                         | 100% | 32   | 0                         | 100% | 32   | 0                      | 100%                  |
| 43   | 0                         | 100% | 43   | 0                         | 100% | 43   | 0                      | 100%                  |
| 77   | 0                         | 100% | 77   | 0                         | 100% | 77   | 0                      | 100%                  |
| 146  | 0                         | 100% | 146  | 0                         | 100% | 146  | 0                      | 100%                  |
| 198  | 0                         | 100% | 198  | 0                         | 100% | 198  | 0                      | 100%                  |
| 249  | 13%                       | 87%  | 249  | 13%                       | 87%  | 284  | 14%                    | 86%                   |
| 325  | 13%                       | 87%  | 325  | 13%                       | 87%  | 325  | 14%                    | 86%                   |
| 353+   | 13%                       | 87%  | 353+   | 13%                       | 87%  | 353+   | 14%                    | 86%                   |

- Cumulative calendar year catastrophe losses and related expenses are in millions.
- AIC and AGI to be allocated equally.
- AMI, AMF, AMG, and ASI to be allocated according to this group's relative pool percentages in effect.
- Catastrophe losses are to be accumulated during each annual calendar period.

### **Reinsurance Assumed**

At December 31, 2001, the Company's only active contract for reinsurance assumed, (outside the intercompany reinsurance pool), was with Renaissance Reinsurance Ltd. This Catastrophe Portfolio Participation Reinsurance contract was effective July 1, 2001, Reinsured losses payable under subject contract amounted to \$4,796,000, at December 31, 2001. This amount is less than materiality for examination purposes.

### **Reinsurance Ceded**

As of December 31, 2001, the following contracts for ceding reinsurance were applicable to the Company:

Lloyd's of London and St. Paul Fire and Marine - Traditional Excess Catastrophe Reinsurance Contract, effective January 1, 2001, on fire and allied Lines, inland marine and the property perils only of homeowners, mobile homeowners, farmowners and commercial multiple peril (including businessowners and church business).

Lloyd's of London is the leading company with other various unauthorized U.S. and alien reinsurers under this contract with 19.25% participation in the Fifth Traditional Excess Catastrophe Reinsurance and 37.50% participation in the Seventh Traditional Excess Catastrophe Reinsurance.

St. Paul Fire and Marine has 5.40% participation in the Fifth Traditional Excess Catastrophe Reinsurance and 6.75% participation in the Seventh Traditional Excess Catastrophe Reinsurance.

Retention and limits were as follows:

- As respects each excess layer of reinsurance coverage provided by this contract, the Company shall retain and be liable for the first amount of ultimate net loss, shown in the table below as the Company's retention for that excess layer, arising out of each loss occurrence. The reinsurer shall then be liable, as respects each excess layer, for the amount by which such ultimate net loss exceeds the Company's applicable retention, but the liability of the reinsurer under each excess layer shall not exceed the amount (shown as reinsurer's per occurrence limit below) as respects any one loss occurrence.
- The Company shall retain a 5.0% part of a 100% share in the interests and liability of the "reinsurer" under this contract.
- The Company shall be permitted to carry excess catastrophe reinsurance, recoveries under which shall inure solely to the benefit of the Company and be entirely disregarded in applying all of the provisions of this contract.
- As respects any one loss occurrence involving loss in excess of policy limits and/or extra contractual obligation awards, this contract shall not apply to such loss in excess of policy limits and/or extra contractual obligations unless the loss occurrence involves two or more risks insured by the Company.

|                                  | Fifth Excess  | Seventh Excess |
|----------------------------------|---------------|----------------|
| Company's Retention              | \$100,000,000 | \$170,000,000  |
| Reinsurer's per Occurrence Limit | \$50,000,000  | \$40,000,000   |
| Reinsurer's Annual Limit         | \$100,000,000 | \$80,000,000   |

National Union Fire Insurance Company - Second Combined Excess Reinsurance Contract, effective January 1, 1993, on fire and allied lines, inland marine, and the property perils only of homeowners, mobile home, farmowners, and commercial multiple peril (including businessowners and church business). The following coverages shall apply:

- Coverage A – the Company shall retain and be liable for the first \$50,000,000 of ultimate net loss arising out of each loss occurrence. The reinsurer shall then be liable for 20% of the amount by which such ultimate net loss exceeds said retention, but the liability of the reinsurer shall not exceed 20% of \$10,000,000 as respects any one loss occurrence, nor shall it exceed 20% of \$10,000,000, as respects all loss occurrence commencing during any one contract year.
- Coverage B – the Company shall retain and be liable for the first \$60,000,000 of ultimate net loss arising out of each loss occurrence. The reinsurer shall then be liable for 8.5% of the amount by which such ultimate net loss exceeds said retention, but the liability of the reinsurer shall not exceed 8.5% of \$40,000,000 as respects all loss occurrences commencing during any one contract year.
- Coverage C – the Company shall retain and be liable for the first \$150,000,000 of ultimate net loss arising out of each loss occurrence. The reinsurer shall then be liable for 10% of the amount by which such ultimate net loss exceeds said retention, but the liability of the reinsurer shall not exceed 10% of \$20,000,000 as respects any one loss occurrence, nor shall it exceed 10% of \$20,000,000 as respects all loss occurrences commencing during any one contract year.
- Coverage D – the Company shall retain and be liable for the first \$100,000,000 of ultimate net loss arising out of each loss occurrence. The reinsurer shall then be liable for 2.4% of the amount by which such ultimate net loss exceeds said retention, but the liability of the reinsurer shall not exceed 2.4% of \$50,000,000 as respects any one loss occurrence, nor shall it exceed 2.4% of \$50,000,000 as respects all loss occurrences commencing during any one contract year.
- Coverage E – the Company shall retain and be liable for the first \$260,000,000 of ultimate net loss arising out of each loss occurrence. The reinsurer shall then be liable for 10% of the amount by which such ultimate net loss exceeds said retention, but the liability of the reinsurer shall not exceed 10% of \$24,000,000 as respects any one loss occurrence, nor shall it exceed 10% of \$24,000,000 as respects all loss occurrences commencing during any one contract year.

General Reinsurance Corporation - contracts are as follows:

- Excess of Loss Reinsurance- effective January 1, 1998, on property business. The Company's retention for the first excess cover was \$500,000 and the second excess cover is \$1,000,000. The limit of liability of the reinsurer will not exceed a total payment of net loss and adjustment expense combined under the first excess cover of \$1,500,000 or under the second excess of \$3,000,000 all risks involved in one occurrence. This agreement also includes excess of loss reinsurance of liability business and insurance agents' errors and omissions business. The Company's

retention is \$500,000 for the first excess cover and the second excess cover is the difference between \$2,000,000 and the sum of the indexed Company Retention and the First Excess Cover.

- Quota Share and Excess of Loss Reinsurance of Personal Umbrella Business-effective July 1, 1998, on automobile liability, licensed recreational vehicles, uninsured/underinsured motorists coverages, business pursuits, employers liability, personal liability and unlicensed recreational vehicles and watercraft liability. In determining the Company's retention and limit of liability of the reinsurer, the limit of liability of the Company with respect to any one policy shall be deemed not to exceed \$5,000,000 each occurrence.
- Quota Share and Excess of Loss Reinsurance of Farm Personal Umbrella Business-effective July 1, 1998, on automobile liability, licensed recreational vehicles, uninsured/underinsured motorists coverages, business pursuits, employers liability, farm liability, personal liability and unlicensed recreational vehicles, and watercraft liability. In determining the Company's retention and limit of liability of the reinsurer, the limit of liability of the Company with respect to any one policy shall be deemed not to exceed \$5,000,000 each occurrence.
- Quota Share and Excess of Loss Reinsurance of Commercial Umbrella Business, effective July 1, 1998, on commercial general liability, comprehensive automobile liability including hired and non-owned auto coverage and uninsured/underinsured motorists coverages, comprehensive automobile liability for school/church buses, watercraft liability, employers' liability, and professional liability. In determining the Company retention and limit of liability of the reinsurer, the limit of liability of the Company with respect to any one policy shall be deemed not to exceed \$5,000,000 each occurrence/ \$5,000,000 aggregate (where applicable).
- Quota Share and Excess of Loss Reinsurance of Commercial Umbrella Business produced by American Direct- effective July 1, 1998, on commercial general liability, comprehensive automobile liability including hired and non-owned auto coverage and uninsured/underinsured motorists coverages, comprehensive automobile liability of school/church buses, watercraft liability, employer' liability, and professional liability. In determining the Company retention and limit of liability of the reinsurer, the limit of liability of the Company with respect to any one policy shall be deemed not to exceed \$5,000,000 each occurrence/ \$5,000,000 aggregate (where applicable).

St. Paul Fire and Marine 70% -

Berkley Insurance Company 30% - Combined Catastrophe Excess of Loss Reinsurance Contract, effective January 1, 2001, on fire and allied Lines, mobile home, inland marine, automobile physical damage and the property perils only of homeowners, farmowners and commercial multiple peril. The following coverages shall apply:

- Coverage A - As respects losses arising out of occurrences commencing during the contract period commencing November 1, 1996, and each subsequent contract period, Alfa shall retain and be liable for the first \$50,000,000 of ultimate net loss

arising out of each loss occurrence. The reinsurer shall then be liable for 60% of the amount by which such ultimate net loss exceeds the Company's retention, but the liability of the reinsurer shall not exceed 60% of \$10,000,000 as respects any one loss occurrence, nor shall it exceed 60% of 10,000,000 as respects any one contract period.

- Coverage B - As respects losses arising out of occurrences commencing during the contract period commencing November 1, 1996, and each subsequent contract period, the Company shall retain and be liable for the first \$60,000,000 of ultimate net loss arising out of each loss occurrence. The reinsurer shall then be liable for 50% of the amount by which such ultimate net loss exceeds the Company's retention, but the liability of the reinsurer shall not exceed 50% of \$40,000,000 as respects any one loss occurrence, nor shall it exceed 50% of \$40,000,000 as respects any one contract period.
- Coverage C - As respects any losses arising out of occurrence commencing during the contract period commencing November 1, 1996, and each subsequent contract period, the Company shall retain and be liable for the first \$150,000,000 of ultimate net loss arising out of each loss occurrence. The reinsurer shall then be liable for 75% of the amount by which such ultimate net loss exceeds the Company's retention, but the liability of the reinsurer shall not exceed 75% of \$20,000,000 as respects any one loss occurrence, nor shall it exceed 75% of \$20,000,000 as respects any one contract period.
- Coverage D - As respects losses arising out of occurrences during the contract period commencing January 1, 1998, and each subsequent contract period, the Company shall retain and be liable for the first \$100,000,000 of ultimate net loss arising out of each loss occurrence. The reinsurer shall then be liable for 16% of the amount by which such ultimate net loss exceeds the Company's retention, but the liability of the reinsurer shall not exceed 16% of \$50,000,000 as respects any one loss occurrence, nor shall it exceed 16% of \$50,000,000 as respects any one contract period.
- Coverage E - The Company shall retain and be liable for the first \$260,000,000 of ultimate net loss arising out of each loss occurrence. The reinsurer shall then be liable for 56.25% of the amount by which such ultimate net loss exceeds said retention, but the liability of the reinsurer shall not exceed 56.25% of \$24,000,000 as respects any one loss occurrence, nor shall it exceed 56.25% of \$24,000,000 as respects all loss occurrences commencing during any one contract period.

Effective January 1, 1997, with respect to losses arising out of loss occurrences commencing on or after that date, the Company was deleted as a named reinsured under the National Union Fire Insurance Company and General Reinsurance Corporation contracts. Effective January 1, 2001, the Company was reentered as a named reinsured under each of the contracts.

All of the contracts for ceded reinsurance contained the usual insolvency clause, which provides for payments to a receiver or statutory successor without diminution, in the event of the insolvency of the ceding company.

## **MARKET CONDUCT**

### **Plan of Operation**

The Company markets its products through captive agents. At December 31, 2001, the Company had 394 service centers in Alabama, employing 487 agents appointed to write its business. The Company did not write business outside Alabama during the examination period, although it is licensed in two other States.

For the year 2001, fire insurance comprised about 74% of the Company's total direct business written. Allied lines business comprised another 18%, and the remaining 4% was comprised of inland marine. Nevertheless, more than 95% of the Company's premiums in 2001 came from reinsurance assumed from the intercompany reinsurance pool, discussed under the caption, "Reinsurance," subsection "Intercompany Reinsurance Pooling Agreement." Reinsurance assumed through the pool was more varied, with automobile and homeowner business accounting for about 77% of the total net premiums.

The Company did not disclose any plans for acquisitions or expansion in the future.

### **Policy Forms and Underwriting**

All the Company's active policy forms and rates in force at December 31, 2001 were found to have been approved by the Alabama Department of Insurance. Rates were filed independently on the Company's direct business.

Membership in the Alabama Farmers Federation was a prerequisite to the issuance of a policy with the Company. The Company's policy is to cancel coverage when Federation membership is not renewed, except on those policies involving a real property lien holder.

### **Compliance With Agents Licensing Requirements**

In order to verify compliance with agents licensing requirements of the Alabama Department of Insurance (ALDOI), a sample of the Company's commission payments

was checked against the licensing records of the ALDOI. No discrepancies were found in the sample.

### **Advertising**

The Company's advertising was planned and coordinated by Creative Consultants, Inc, a wholly-owned subsidiary of the Alabama Farmers Federation. The cost of advertising was shared on a proportionate basis with other participating affiliates of the Company and the Alabama Farmers Federation. Various types of advertising were utilized, such as, signs, billboards, newspaper advertisements and spot advertisements on radio and television. The Company also has a Web page ([www.alfains.com](http://www.alfains.com)), which displays the following links: Company's background, product lines, employment opportunities, agent access, how to locate an agent or the Farmers Federation and investing in Alfa stock.

The Company also maintained a cooperative advertising program with its agents. Company sponsored advertising materials were made available to the agents for their advertising purposes. Advertisement costs were shared on a 50/50 basis with the agents when the advertising was approved by the Company and paid invoices were submitted by the agent.

### **Claims Payments Practices**

A random sample of open, closed and closed without payment claim files was reviewed in order to evaluate the Company's claims payment practices. Claims sampled were reviewed with regard to compliance with policy provisions, timeliness of payments, and adequacy of documentation. No noteworthy discrepancies were found within the sample.

### **Complaints**

The files of the Alabama Department of Insurance (ALDOI) were reviewed for complaints against the Company. The overall number of complaints during the examination period was deemed to be low in relation to the amount of the Company's business. However, the Company did not maintain a record of those complaints that were made directly to the Company and not reported to the ALDOI.

The NAIC Market Conduct Handbook stipulates that a complaint register should include consumer direct complaints as well as those complaints filed with regulatory authorities.



## **Privacy**

The Company's policy is that non-public information involving underwriting, marketing, claims handling and fraud prevention is not shared with anyone outside the Company except for that sharing allowed by the exceptions in the Gramm-Leach-Bliley Act (GLBA). The insured receives a Privacy Notice at the point of sale and the Company sends a Privacy Notice to the insured on an annual basis. The Company appeared to be in compliance with the privacy requirements of Alabama Department of Insurance, *Regulation No. 122*.

## **ACCOUNTS AND RECORDS**

### **Internal Accounting Records**

The Company's internal controls and information systems are those of Alfa Mutual Insurance Company (AMI), since the Company is operated by AMI, in accordance with a "Manage and Operating Agreement," among AMI and its affiliates. See "Holding Company and Affiliates," subsection, "Agreements with Affiliates" for details of the agreement. Said internal controls and information systems were reviewed during the concurrent examination of AMI. They appeared to be sufficient to safeguard Company assets and to generate adequate records of its business. The Company's accounting systems and documentation of its transactions were deemed to be adequate.

AMI's internal audit department reports to management, rather than to the Audit Committee of the Board of Directors. Most of the reports generated by internal audit were concerned with agency transactions and service center accounting. Internal audit reports were made available to the examiners, but were of limited use for examination purposes.

### **External Audit and Actuarial**

The Company and its affiliates were audited, on a statutory basis, for each of the years under examination by the certified public accounting firm of KPMG, LLP. The audit reports and work papers of the external auditors were made available to the examiners, and have been utilized in the examination to the extent deemed appropriate.

The Company's reserves were certified, as of December 31, 2001, by Scott Weinstein, FCAS, MAAA of KPMG LLP, of Atlanta, Georgia.

## **FINANCIAL STATEMENTS**

Financial statements included in this report, which reflect the operations of the Company for the years under examination and financial condition at December 31, 2001, consist of the following:

|   | <u>Page</u> |
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| Statement of Income . . . . .                                       | 25          |
| Reconciliation of Surplus as Regards Policyholders . . . . .        | 26          |

***THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.***

# STATEMENT OF ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS

For the Period Ended December 31, 2001

## ASSETS

|  | <u>Assets</u>         | <u>Non-Admitted<br/>Assets</u> | <u>Admitted<br/>Assets</u> |
|--|-----------------------|--------------------------------|----------------------------|
| Bonds                                      | \$ 442,128,957        |                                | \$ 442,128,957             |
| Preferred stocks                           | 4,705,000             |                                | 4,705,000                  |
| Common stocks                              | 121,793,342           |                                | 121,793,342                |
| Real estate:                               |                       |                                |                            |
| Held for production of income              | 5,910,986             | \$ 58,625                      | 5,852,361                  |
| Held for sale                              | 2,075,613             |                                | 2,075,613                  |
| Cash                                       | 14,207,904            |                                | 14,207,904                 |
| Short-term investments                     | 14,491,021            |                                | 14,491,021                 |
| Other invested assets                      | 52,737,650            |                                | 52,737,650                 |
| Receivable for securities                  | 3,374                 |                                | 3,374                      |
| Installment premium plan                   | 5,982,330             |                                | 5,982,330                  |
| Stock options owned                        | 113,200               | 111,200                        | 2,000                      |
| Premiums in course of collection           | 48,580                | 726                            | 47,854                     |
| Funds held by reinsured companies          | 3,508,774             | 112,775                        | 3,395,999                  |
| Reinsurance recoverable                    | 60,974                |                                | 60,974                     |
| Federal income tax recoverable             | 1,710,883             |                                | 1,710,883                  |
| Interest, dividends and real estate income | 6,387,553             |                                | 6,387,553                  |
| Receivable from affiliates                 | 8,393,629             |                                | 8,393,629                  |
| Accounts receivable                        | 303,877               | 121,239                        | 182,638                    |
| Prepaid expenses                           | 348,246               | 348,246                        | -                          |
| Rounding                                   | (18)                  | (1)                            | (17)                       |
| Total Assets                               | <u>\$ 684,911,875</u> | <u>\$ 752,810</u>              | <u>\$ 684,159,065</u>      |

## STATEMENT OF ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS (continued)

### LIABILITIES SURPLUS AND OTHER FUNDS

#### Liabilities

|  |                |
|--|----------------|
| Losses ( <i>Note - 1</i> )                         | \$ 27,221,716  |
| Loss adjustment expenses ( <i>Note - 1</i> )       | 2,571,455      |
| Other expenses                                     | 1,634,033      |
| Taxes, licenses and fees                           | 215,672        |
| Federal income taxes                               | 14,928,781     |
| Unearned premiums                                  | 32,123,237     |
| Funds held by Company under reinsurance treaties   | 24,595,433     |
| Amounts withheld or retained for account of others | 1,513,461      |
| Drafts outstanding                                 | 99,824         |
| Payable to affiliates                              | 2,113,653      |
| Payable for securities                             | 8,285,270      |
| Option liabilities                                 | 242,200        |
| Reserve for advance premium                        | 4,792,641      |
| Reserve for premium deficiency ( <i>Note - 2</i> ) | 348,115        |
| Rounding   | (6)            |
| Total liabilities                                  | \$ 120,685,485 |

#### Surplus and Other Funds

|  |                       |
|--|-----------------------|
| Partnership capital commitment - special surplus | \$ 21,806,672         |
| Unassigned funds (surplus) ( <i>Note - 3</i> )   | <u>541,666,908</u>    |
| Surplus as regards policyholders                 | <u>563,473,580</u>    |
| Total liabilities, surplus and other funds       | <u>\$ 684,159,065</u> |

# STATEMENT OF INCOME

For the Periods Ended,

|  | <u>December</u><br><u>31, 2001</u> | <u>December</u><br><u>31, 2000</u> | <u>December</u><br><u>31, 1999</u> | <u>December</u><br><u>31, 1998</u> |
|--|------------------------------------|------------------------------------|------------------------------------|------------------------------------|
| Underwriting income:                                 |                                    |                                    |                                    |                                    |
| Premiums earned                                      | \$ 98,281,997                      | \$ 2,250,669                       | \$ 301,870                         | \$ 32,245                          |
| Deductions:  |                                    |                                    |                                    |                                    |
| Losses incurred                                      | \$ 77,106,527                      | \$ (297,503)                       | \$ (554,572)                       | \$ (735,177)                       |
| Loss expenses incurred                               | 3,659,283                          | 227,729                            | (208,114)                          | (52,182)                           |
| Other underwriting expenses incurred                 | 37,323,913                         | 5,997,838                          | 943,282                            | 816,989                            |
| Premium deficiency                                   | 202,937                            |                                    |                                    |                                    |
| Total deductions                                     | \$ 118,292,660                     | \$ 5,928,064                       | \$ 180,596                         | \$ 29,630                          |
| Net underwriting gain (loss)                         | \$ (20,010,663)                    | \$ (3,677,395)                     | \$ 121,274                         | \$ 2,615                           |
| Investment income:                                   |                                    |                                    |                                    |                                    |
| Net investment income earned                         | \$ 39,325,927                      | \$ 37,494,045                      | \$ 34,343,860                      | \$ 31,452,619                      |
| Net realized capital gains (losses)                  | (2,943,028)                        | 908,665                            | 9,883,950                          | 4,757,680                          |
| Net investment gain (loss)                           | \$ 36,382,899                      | \$ 38,402,710                      | \$ 44,227,810                      | \$ 36,210,299                      |
| Other income:  |                                    |                                    |                                    |                                    |
| Finance and service charges not included in premiums | \$ 1,055,744                       |                                    | \$ 176,000                         |                                    |
| Miscellaneous income                                 | 7                                  |                                    | \$ 176,000                         |                                    |
| Total other income                                   | \$ 1,055,751                       |                                    | \$ 34,725,315                      | \$ 36,212,914                      |
| Net income before dividends and taxes                | \$ 17,427,987                      | \$ 34,725,315                      | \$ 44,525,084                      | \$ 36,212,914                      |
| Federal income taxes                                 | 7,274,681                          | 10,418,542                         |                                    |                                    |
| Net income   | \$ 10,153,306                      | \$ 24,306,773                      | \$ 44,525,084                      | \$ 36,212,914                      |

# RECONCILIATION OF SURPLUS AS REGARDS POLICYHOLDERS

For the Periods Ended December 31,

|   | <u>2001</u>    | <u>2000</u>    | <u>1999</u>    | <u>1998</u>    |
|---|----------------|----------------|----------------|----------------|
| Surplus as regards policyholders, January 1,          | \$ 564,857,644 | \$ 530,763,001 | \$ 479,637,960 | \$ 440,465,755 |
| Net income  | \$ 10,153,306  | \$ 24,306,773  | \$ 44,525,084  | \$ 36,212,914  |
| Net unrealized capital gains or (losses)              | 2,493,335      | 9,691,910      | 6,546,143      | 2,942,021      |
| Change in net deferred income tax                     | 4,073,076      |                |                |                |
| Change in non-admitted assets                         | (264,197)      | 35,361         | 1,102          | (99,710)       |
| Change in provision for reinsurance                   |                |                |                |                |
| Change in excess of statutory reserves                |                | 6,668          | (4,314)        | 75,912         |
| Cumulative effect of changes in accounting principles | (17,823,520)   |                |                |                |
| Direct entries to surplus                             | 105,820        | 53,930         | 57,027         | 43,998         |
| Adjustment in prior year income tax liability         | (121,894)      |                |                | (2,929)        |
| Prior year premium tax                                |                |                |                |                |
| Rounding  | 10             | 1              | (1)            | (1)            |
| Change in surplus as regards policyholders            | \$ (1,384,064) | \$ 34,094,643  | \$ 51,125,041  | \$ 39,172,205  |
| Surplus as regards policyholders, December 31,        | \$ 563,473,580 | \$ 564,857,644 | \$ 530,763,001 | \$ 479,637,960 |

## **NOTES TO THE FINANCIAL STATEMENTS**

### **Note 1 – Losses**

**\$27,221,716**

#### **Loss Adjustment Expenses**

**\$ 2,571,455**

The amounts of the captioned liabilities are the same as the amounts reported in the Company's 2001 Annual Statement. However, the amounts per examination differed as follows. The amount of losses determined per examination was \$27,372,000, or \$150,284 more than the amount reported. The amount of Loss Adjustment Expenses (LAE) determined by examination was \$2,133,000, or \$438,455 less than the amount reported. The net examination difference is \$288,171, and is not material for the purposes of this report. Therefore, no related changes have been made to the financial statements contained herein. These examination differences were developed by the actuarial examiners, and were based on the following findings.

In the opinion of the actuarial examiners, the 2001 Annual Statement reserves were reasonably conservative given the information available at year-end 2001. However, the range of possible outcomes becomes narrower with the passage of time. Given actual development through year-end 2002, it is the opinion of the actuarial examiners that the 2001 Annual Statement reserves are outside the range of reasonable reserves. Therefore, adjustments are recommended for examination purposes. Consistent with the requirements for the statutory actuarial reserves opinion, the examination reserves must be within the range of reasonable reserves defined by the independent actuarial analyses of the actuarial examiners.

Company management explained that the approximate 85<sup>th</sup> percentile confidence level was targeted at year-end 2001, in order to book reserves at a conservative level. Company management stated that they wished to book reserves at a level where favorable development is more likely than adverse development. SSAP #55, paragraph 10 states that management shall record their best estimate of liabilities for unpaid losses and LAE. Upon detailed review of this guidance, it was determined that the NAIC did not intend this to be a strict guidance. It was determined that reasonably conservative reserve levels should not be specifically prohibited in the consideration of management's best estimate.

It was also the opinion of the actuarial examiners that the reserve redundancy was partially due to the data used to calculate defense and cost containment (DCC) reserves. Both the Company's actuary and the opining actuary relied upon an inconsistent mix of allocated loss adjustment expenses (ALAE) and DCC data in their respective reserve analyses. These actuaries were aware of the inconsistencies and attempted to judgmentally adjust their selections accordingly. In the opinion of the actuarial examiners, those adjustments were subjective. The results of the examination

reserve analyses, which used DCC-only data in the projection of DCC reserves, imply that the booked DCC reserves were conservative.

**Note 2 – Premium Deficiency Reserve**

**\$348,115**

The amount of the captioned liability is the same as reported in the Company's 2001 Annual Statement. The actuarial examination of this reserve determined that it was not necessary and that the amount per examination was \$-0-. The difference is not deemed to be material and no related change has been made in the financial statements of this report.

Premium deficiency reserves (PDR) in the aggregate amount of \$1,691,314 were calculated for the participants in the reinsurance pool. The aggregate PDR was allocated to each company based on the pooling percentages (including catastrophe-layer pooling) in effect at year-end 2001. The resulting PDR for the Company was \$348,115. See the report caption "Reinsurance" for details of the Company's participation in the reinsurance pool.

PDR liabilities are relatively rare for insurance companies writing standard personal lines insurance products. Since PDR is a relatively new item in statutory accounting, the Company's actuaries did not have significant historical guidance in establishing the PDR methodology. Therefore, they applied judgment, tempered with conservative assumptions to estimate PDR reserves. The actuarial examiners reviewed the assumptions and provided additional guidance relating to the PDR calculation. Some of the assumptions that contributed to the conservative results are briefly discussed as follows:

- The Company assumed that none of the other acquisition or general expenses are paid at or before policy inception. It is more common to assume that all of other acquisition expenses and a portion of general expenses are paid at or before policy inception.
- The PDR calculation incorporated discounting of losses and LAE for one-half of a year, whereas anticipated incurred losses could be discounted to the expected loss payment date. The discounting calculation assumed that all general expenses and other acquisition expenses are pre-paid. That assumption is inconsistent with the assumption listed above.
- The PDR calculation was conducted separately for each line of business for each direct book of business. The Company should have combined products that are marketed together and combined for profitability analysis. For instance, it is common to assume that auto liability and physical damage products are marketed on a combined basis.



The actuarial examiners conducted independent analyses of PDR, resulting in no indicated liability related to net unearned premiums as of year-end 2001.

**Note 3 – Unassigned Funds (surplus)**

**\$541,666,908**

The amount of unassigned funds per examination is the same as reported in the Company's 2001 Annual Statement. Variances in account balances determined by the examination were deemed to be immaterial in the aggregate amount.

**CONTINGENT LIABILITIES AND PENDING LITIGATION**

The examination for contingent liabilities and pending litigation included review of the Company's Annual Statement disclosures, minutes of the corporate governing bodies, pending claims, and the usual examination of the accounts for unrecorded items. No material unreported contingencies were noted and all litigation pending against the Company, at December 31, 2001, appeared to be within the ordinary course of its business. See "Subsequent Event," next page, for discussion of a contingency that was effective January 1, 2002.

The Company's Chief Executive Officer and its Chief Financial Officer executed a letter of representation, attesting to the non-existence of unreported liabilities and contingencies as of December 31, 2001.

**SUBSEQUENT EVENTS**

The review of events subsequent to December 31, 2001 and up to the date of this report included: review of the Company's 2002 Annual Statement; review of cash disbursements through December 31, 2002; review of corporate records through October of 2003; and, inquiries of Company management. No subsequent events were identified that were deemed to have an impact on this examination; and, no subsequent events were identified that might potentially have a material impact on the Company's continued operations and/or financial condition, except as follows.

The Company disclosed the following contingency in its 2001 Annual Statement, Notes to the Financial Statements. Effective January 1, 2002, the Company agreed to guarantee, on behalf of Alfa Ventures II, LLC, one-half of the outstanding indebtedness, up to \$25,000,000, of a loan from Columbus Bank and Trust Company, for the construction of a shopping mall.

## **COMPLIANCE WITH PREVIOUS RECOMMENDATIONS**

It appeared that the Company had complied with all recommendations made as a result of the examination report as of December 31, 1997, except for the recommendation relating to fidelity bond coverage. See "Comments and Recommendations, Fidelity Bond and Other Insurance," which follows for the current recommendation.

## **COMMENTS AND RECOMMENDATIONS**

### **Management and Control – Conflict of Interest – Page 12**

The Company's conflict of interest policy was changed during the examination period, and subsequently amended to add the requirements of the Federal Sarbanes-Oxley Act. Annual reporting requirements have been eliminated under the new policy.

### **Fidelity Bond and Other Insurance – Page 12**

The Company's fidelity bond coverage was found inadequate to cover the twenty-two affiliates that are named insured on the policy. The Company has agreed to compute the required amount of coverage, based on a consolidation of the assets and income of all the named insured, and increase its coverage accordingly.

### **Market Conduct – Complaints – Page 20**

It is recommended that the Company maintain a complaints register that includes all complaints received, rather than just those that are filed with regulatory agencies.

### **Losses & Loss Adjustment Expenses – Page 27**

The loss and LAE reserves reported in the Company's 2001 Annual Statement were found to meet the requirements of SSAP #55, at the time said reserves were reported. Based on development through year-end 2002, said reserves were not within a reasonable range; however, the differences were not deemed to be material and no related changes have been made in the financial statements of this report.

**Premium Deficiency Reserve – Page 28**

The Company's PDR liability has been adjusted to zero for examination purposes. It is recommended that the Company re-evaluate its PDR calculations and assumptions for future analyses, and statutory reporting purposes.

## **CONCLUSION**

Acknowledgement is hereby made of the courtesy and cooperation extended by representatives of **Alfa Mutual Fire Insurance Company** during this examination.

The customary examination procedures, as recommended by the National Association of Insurance Commissioners, have been followed to the extent appropriate in connection with the verification and valuation of assets and the determination of liabilities set forth in this report.

Examination findings indicated that the Company was in sound financial condition as of December 31, 2001.

In addition to the undersigned, the following persons represented the Alabama Department of Insurance as participants in this examination: Palmer W. Nelson, AFE, Douglas T. Brown, Thomas W. Salo, Theophilos C. Goodin, Deanne Brown, Larae Mason and Bobby Mckinnon, examiners; Glenn Taylor, ACAS, MAAA, and Randall D. Ross, actuarial consultants.

Respectfully submitted,  
February 20, 2004



Rex H. Newborn, CFE  
Examiner-in-Charge  
Alabama Department of Insurance

EXAMINER'S AFFIDAVIT AS TO STANDARDS AND PROCEDURES  
USED IN AN EXAMINATION

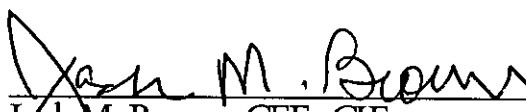
STATE OF ALABAMA

COUNTY OF MONTGOMERY

Jack M. Brown, being duly sworn, states as follows:


1. I have authority to represent the State of Alabama in the examination of Alfa Mutual Fire Insurance Company, Montgomery, Alabama.
2. The Alabama Department of Insurance is accredited under the National Association of Insurance Commissioners Financial Regulation Accreditation Standards.
3. I have reviewed the examination workpapers and examination report, and the December 31, 2001 examination of Alfa Mutual Fire Insurance Company, Montgomery, Alabama was performed in a manner consistent with the standards and procedures required by the State of Alabama Department of Insurance, and the National Association of Insurance Commissioners.

The affiant says nothing further.

  
\_\_\_\_\_  
Jack M. Brown, CFE, CIE  
Assistant Chief Examiner, and Insurance Examinations Supervisor  
State of Alabama, Department of Insurance

Subscribed and sworn before me by Jack M. Brown, on this 16<sup>th</sup> day of July, 2004.

(SEAL)

  
\_\_\_\_\_  
(Notary Public)

My commission expires 11/2/05  
(Date)